Blank Page

FILE COPY

Office - Supreme Court, U. S.
FILED
APR 15 1940
CHARLES ELMORE CROPLEY
CLERK

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1939

No. [redacted] 55

DONALD S. McCLAIN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

M. E. KILPATRICK,
E. D. SMITH, JR.,
Counsel for Petitioner.

Blank Page

INDEX

PETITION FOR WRIT OF CERTIORARI

	Page
Judgment and Opinion Below	1
Statutes Involved	2
Reasons for Granting Writ	2
Question Presented	2, 3
Statement of the Case	3, 4, 5
Certification of Error	5
Importance of Question	5, 6
Conclusion	6

TABLE OF CITATIONS

Revenue Act of 1934	
Section 23 (k)	3, 4, 5
Section 117 (f)	2, 3, 5
S. C. Thomson v. Commissioner of Internal Revenue, 108 Fed. (2) 642 (January 8, 1940)	2

INDEX

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

	Page
Jurisdiction	7
Question Involved	7
Conflict Between Circuits	7
Intention of Congress	8, 9, 10
Confusion Within Fifth Circuit Court of Appeals	10
Board of Tax Appeals	10

TABLE OF CITATIONS

Austin Corbin, 2d, v. Commissioner,
39 B. T. A. 1163, at page 1169 10

Fairbanks v. United States,
306 U. S. 436, 59 Sup. Ct. Rep. 607 ..... 8, 10

Henry R. Hunting v. Commissioner,
32 B. T. A. 495 8

Stewart v. United States,
106 Fed. (2d) 405, headnote 8 10

W. A. Thomas, Collector, v. Perkins,
108 Fed. (2d) 87 10

S. C. Thomson v. Commissioner of Internal Revenue,
108 Fed. (2d) 642 (January 8, 1940) 7

John H. Watson v. Commissioner,
27 B. T. A. 463 ..... 8, 9

Henry P. Werner v. Commissioner,
15 B. T. A. 482 8

Paul and Mertens Law on Federal Income Taxation,
par. 28.87 8

Judicial Code Section 240, (Title 28 U. S. C. A.
Sec. 347) 7

House of Representatives Committee Report No. 1860 9

Revenue Act of 1932 9

Revenue Act of 1934
Section 23 (k) 7, 9
Section 117 (f) 7, 8, 9

Revenue Act 1938
Section 23 (k) 2 ..... 9, 10

Regulations 86
Article 23 (k) (4) 9

Blank Page

IN THE

Supreme Court of the United States

OCTOBER TERM, 1939

DONALD S. McCLAIN, PETITIONER

vs.

THE COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

No.....

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner respectfully petitions for a writ of certiorari to review a judgment of the Circuit Court of Appeals for the Fifth Circuit, and for reason therefor respectfully shows the following:

JUDGMENT AND OPINION BELOW

The judgment sought to be reviewed was entered on March 23, 1940, by the Circuit Court of Appeals for the Fifth Circuit in the case of "Donald S. McClain, Appellant, v. Commissioner of Internal Revenue, Appellee" (R. p. 30).

The judgment of the Circuit Court of Appeals aforesaid affirmed the decision of the Board of Tax Appeals. The memorandum opinion of the Board of Tax

Appeals appears (R. p. 19). The decision of the Board of Tax Appeals appears (R. p. 21).

STATUTES INVOLVED

The *Revenue Act of* 1934 is involved in this controversy and this controversy turns upon the construction of *Section* 117 (*f*) thereof.

Revenue Act 1934, *Section* 117 (*f*)

> "Retirement of bonds, etc.—For the purposes of this title, amounts received by the holder upon the *retirement* of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

REASONS FOR GRANTING WRIT

The revenue of the United States of America is involved in this controversy. A direct conflict exists between the Fifth Circuit Court of Appeals in this opinion, and the Second Circuit Court of Appeals in the case of *S. C. Thomson v. Commissioner of Internal Revenue*, 108 *Fed.* (2) 642 (January 8, 1940). Both of these cases deal with the meaning of the word "retirement" as used in *Section* 117 (*f*) of the *Revenue Act of* 1934, and the two courts come to exactly opposite conclusions as to the meaning of that word as there used.

QUESTION PRESENTED

The sole question here presented is whether bonds of a corporation or a political subdivision of a state

are "retired" within the meaning of *Section* 117 (*f*), *Revenue Act of* 1934, when the debtor becomes insolvent and unable to meet its obligations, and the creditor receives payment on the bonds at less than the face value thereof. If a "retirement" is thus effected, the loss is limited by the capital loss provisions of the Revenue Act; if a "retirement" is not thus effected, the loss suffered is as a bad debt and deductible in full by the creditor, taxpayer, under *Section* 23 (*k*) *of the Revenue Act of* 1934.

STATEMENT OF THE CASE

In 1918 Donald S. McClain received as a gift from his father bonds of the Cameron County Water District (Texas) of the face amount and of the value of $15,000. The Cameron County Water Improvement District was a political subdivision of the State of Texas. (R. p. 14)

In 1935 the said water district became financially embarrassed and was in default on both principal and interest on its outstanding bonds. (R. p. 16). After an unsuccessful attempt at bankruptcy, said attempt being unsuccessful because the Municipal Bankruptcy Act was declared unconstitutional, the water district applied to the Reconstruction Finance Corporation for a loan. In the year 1935 it was successful in securing a loan from that corporation to the extent of $264,500, this being sufficient to pay 49.9 per cent of its outstanding bonds. (R. p. 15). The Reconstruction Finance Corporation, prior to making this loan, had made a survey of the properties of the water district and general conditions and had determined that the loan made

was the maximum amount that the water district could stand, and at the same time, meet its current liabilities and charges. (R. p. 16)

After securing this loan from the Reconstruction Finance Corporation, the Cameron County Water District paid to Donald S. McClain the sum of $7,476.75, which amounted to 49.9 per cent of his bonds. (R. p. 17). In view of all of the circumstances bearing upon the financial responsibility of the water district and its inability to meet its obligations, Donald S. McClain accepted this payment and in turn determined the balance of these bonds to be uncollectible in year 1935, and in that year charged off on his books the sum of $7,523.25 as uncollectible, and in his income tax for that year claimed a deduction of that amount, pursuant to the provisions of *Section* 23 (*k*) of the *Revenue Act* of 1934. In other words, he treated the loss suffered by him as a loss upon a debt becoming partially worthless and uncollectible. In fact, the debt became uncollectible during 1935, except to the extent of 49.9 per cent on the dollar. (R. p. 18)

The understanding of Donald S. McClain in accepting the amount agreed on was that he would receive the payment thereon at the rate of 49.9 per cent and that such payment was to be the only amount he would receive. However, there was no writing to evidence this, nor in fact any agreement between the district and the bondholders to this effect. (R. p. 18)

The Commissioner in auditing the returns of Mr. McClain disallowed this deduction and assessed a deficiency. The disallowance of the Commissioner was

based upon his contenton that the bonds had been "retired" within the meaning of *Section* 117 (*f*) of the *Revenue Act of* 1934, and, consequently, the loss suffered was a capital loss limited to $2,000.

CERTIFICATION OF ERROR

The Circuit Court of Appeals erred:

1. In its ruling that the bonds in question were retired within the meaning of *Section* 117 (*f*) of the *Revenue Act of* 1934.

2. In its ruling that the bonds were retired and in ruling that petitioner was not entitled to deduct the loss suffered as for a bad debt.

3. In affirming the decision of the United States Board of Tax Appeals.

IMPORTANCE OF QUESTION

The question here involved is highly important in the administration of the Revenue laws of the United States, because it is a question which is constantly recurring. In every bankruptcy and in every compromise with creditors governed by the Revenue Acts of 1934 and through 1937, the question arises whether the obligations of the insolvent or financially embarrassed debtor are retired within the meaning of *Section* 117 (*f*) of the Revenue Act of 1934, or whether the loss suffered by the creditor is to be treated as a loss upon a debt becoming worthless and treated under *Section* 23 (*k*) of that revenue act. With the irreconcilable conflict existing between the Circuit Court of Appeals

of the Fifth Circuit and the Circuit Court of Appeals of the Second Circuit, endless litigation must necessarily result. It is, therefore, highly important that this court grant ceritorari and settle definitely and finally this question so that taxpayers and litigants may be able to determine their controversy without the necessity of prolonged and expensive litigation.

CONCLUSION

For the reasons stated, it is respectfully submitted that the writ of ceritorari be granted.

DONALD S. MCCLAIN

By M. E. KILPATRICK,
E. D. SMITH, JR.,
Attorneys for Petitioner.

1045 Hurt Building,
Atlanta, Georgia

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

The decision sought to be reviewed is at pages 30-34 of the record.

JURISDICTION

The jurisdiction of this honorable court is based upon *Section* 240 of the *Judicial Code* as amended by the Acts of February 13, 1925 (*Title* 28 *U.S.C.A. Section* 347).

QUESTION INVOLVED

The question involved in this petition for certiorari turns entirely upon the construction of the word "retirement" as used in *Section* 117 (*f*) of the *Revenue Act of* 1934. Reference must also be had to *Section* 23 (*k*) of the same revenue act in dealing with this situation.

CONFLICT BETWEEN CIRCUITS

S. C. Thomson v. the Commissioner of Internal Revenue, 108 *Fed.* (2*d*) 642 (*January* 8, 1940).

Mr. Thomson owned twenty-five thousand dollars ($25,000.00) of the debentures of New York Hotel, Inc. In 1935, after that company had secured an extension from its debenture holders and after receivers had been appointed in the United States District Court on a creditor's bill, Mr. Thomson received a final dividend on his bonds at the rate of five dollars ($5.00) per thousand, thus receiving in all, one hundred twenty-five dollars ($125.00). This payment was the only and final payment on said bonds. In his income tax return for 1935 he treated this loss as a bad debt loss under *Section* 23 (*k*) of the *Revenue Act of* 1934. The

Commissioner disallowed this deduction and treated the loss as having been suffered upon the retirement of the bonds and hence treated the loss as a capital loss under *Section* 117 (*f*) of that revenue act. The Board of Tax Appeals upheld the Commissioner. The Circuit Court of Appeals for the second circuit reversed the Board of Tax Appeals and held that bonds were not retired within the meaning of the Revenue Act when upon the collapse of the debtor they were paid off at less than face value.

From this statement of the Thomson case, it becomes apparent that this case is in irreconcilable conflict with the decision of the Circuit Court of Appeals of the Fifth Circuit in the case here presented by this petition.

INTENTION OF CONGRESS

1.

The prior law allowed a full deduction for loss suffered upon bonds becoming worthless or partially worthless.

Fairbanks v. the United States, 306 *U. S.* 436, 59 *Sup. Ct. Rep.* 607;

Henry R. Hunting v. the Commissioner, 32 *B.T.A.* 495 (*bonds partially worthless*);

John H. Watson v. the Commissioner, 27 *B.T.A.* 463 (*reversing Henry P. Werner*, 15 *B.T.A.* 482);

Paul and Merten, Law of Federal Income Taxation, par. 28.87.

2.

Section 117 (*f*) of the *Revenue Act of* 1934 was aimed at the situation created by the *John H. Watson* case (27 *B.T.A.* 463) which, for the first time, allowed a full deduction for the loss suffered by a bond holder when his bonds matured and were paid off in full. This case was decided December 29, 1932 after the enactment of the *Revenue Act of* 1932. Congress did not have an opportunity to correct this situation until the *Revenue Act of* 1934. The 1934 Act did not attempt to deal with the situation where bonds became worthless or partially worthless.

Revenue Act 1934, *Section* 23 (*k*),

Regulation 86, *Art.* 23 (*k*) 4.

3.

The intention of Congress in the *Revenue Act of* 1934 was made more clear by the *Revenue Act of* 1938, wherein *Section* 23 (*k*) was specifically amended to cover this very situation.

Revenue Act of 1938, *Section* 23 (*k*), 2;

House of Representatives Report No. 1860, *75th Congress, 3rd Session, appearing* 1939-1 *Cumulative Bulletin, page* 728 *at page* 740.

4.

Had Congress intended to cover this situation in 1934, it could easily have added *Section* 23 (*k*) in that year. Also, had Congress thought that the amendment in 1934 covered this situation, then the addition of

sub-Section 2 to Section 23 (k) in the *Revenue Act of* 1938 was a useless thing and without meaning. (The 1938 Act was enacted prior to the decision of the S. C. Thomson case, supra.)

Fairbanks v. the United States, 306 *U. S.* 436, 59 *Sup. Ct. Rep.* 607;

Stewart v. the United States, 106 *Fed.* (2d) 405, *Headnote* 8.

CONFUSION WITHIN FIFTH CIRCUIT COURT OF APPEALS

Confusion exists within the decisions of the Fifth Circuit Court of Appeals by virtue of the case of *W. A. Thomas, Collector v. Perkins*, 108 *Fed.* (2d) 87 (December 7, 1939) which is contrary to its decision in the present case.

BOARD OF TAX APPEALS

The Board of Tax Appeals in dealing with this exact question recognizes that in a proper case loss suffered on bonds becoming worthless, may be deducted in full under the *Revenue Act of* 1934. Such a proper case is here presented.

Austin Corbin, 2d, v. the Commissioner, 39 *B.T.A.* 1163, *at page* 1169.

Respectfully submitted,

HIRSCH, SMITH & KILPATRICK
M. E. KILPATRICK,
E. D. SMITH, JR.
Attorneys for Petitioner

1045 Hurt Building
Atlanta, Georgia

Blank Pag